



# ASSET BACKED COMMERCIAL PAPER WEEKLY NEWSLETTER

6.2.2006

## U.S. ABCP Market Outlook (CP Desk Comments)

### *Market Awaits Further Signals on Inflation (or Lack Thereof)*

We had a rather slow week with sluggish two-way cash flows as it was month-end and the ever-important employment number that everyone was waiting for was released on June 2<sup>nd</sup>. The market is still trying to form some sort of consensus on the Fed's next move by scrutinizing each passing economic release.

On May 31<sup>st</sup>, the Minutes of the May 10<sup>th</sup> FOMC meeting were released causing a lot of excitement as the market perception took a more hawkish tone from those statements. Euro dollar futures sold off rather dramatically, causing LIBOR rates to back up anywhere from 2 to 8 bps throughout the curve as the market took out most of the possibility for the Fed to pause.

Friday's employment number though reversed all this, as it came out much weaker than expected. This reversed Wednesday's sell-off and caused the market to rally (as it put the pause possibility back into play). Putting on your seat belt was definitely in order for the week. The July Fed Funds contract moved from a roughly 58% probability of another 25bps increase at the June 29<sup>th</sup> FOMC meeting in the beginning of the week of May 29<sup>th</sup>, to a 72% probability by June 1<sup>st</sup> and then ended up at a 48% probability by June 2<sup>nd</sup>. Much of the investor interest remains in the one month and in maturity band and will probably remain there as we get closer and closer to the June 29<sup>th</sup> meeting.

Next week, we should hopefully see increased two-way flows as new cash moves into our market for the beginning of the month and existing rolls coming due decide on where to put their next maturity.

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## Euro CP Market Overview (ECP Desk Comments)

Please look for our ECP comments in next week's newsletter.

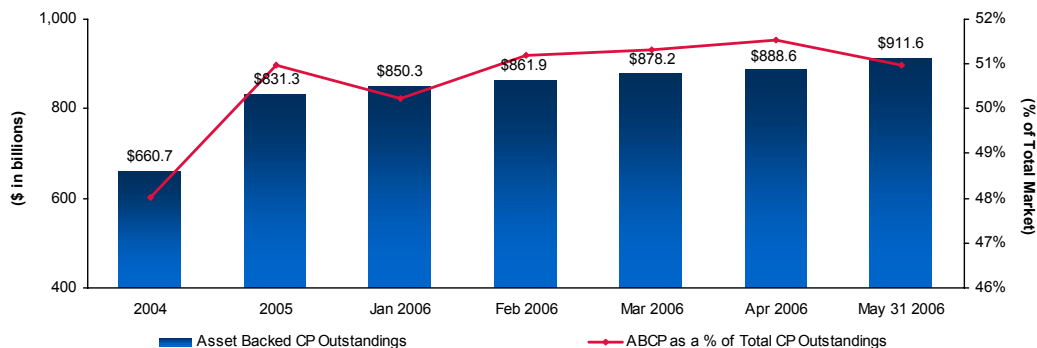
### Credit Suisse Economists' View on Central Bank Rates

Timeframe	US	UK	Euro
Current	5.00%	4.50%	2.50%*
Next Meeting	5.00% (Jun-29)	4.50% (9-Nov)	2.75% (8-Jun)
Year-end	5.00%	4.75%	3.25%

\* Please note that data is as of June 2, 2006

## ABCP Outstanding (under new Fed calculations)

From May 25<sup>th</sup> through May 31<sup>st</sup>, U.S. ABCP outstandings increased by \$3.4 billion to \$911.6 billion from \$908.2 billion. The ABCP market represents approximately 51% of total CP outstandings.



## ABCP Spreads to LIBOR & Trading Levels

### USCP Funding Levels (Offered Side) – May 29<sup>TH</sup> to June 2<sup>ND</sup>

	TIER 1 CORPORATES	TIER 1 US-ABCP
1 Month	L -11 to -7	L -6 to -1
2 Months	L -11 to -7	L -6 to -1
3 Months	L -11 to -7	L -6 to -1

### ECP Spreads (re-offer) – May 29<sup>TH</sup> to June 2<sup>ND</sup>

	US DOLLARS		EUROS	
	1 month	3 months	1month	3 months
Tier 1 Corporates	L -7 to -4	L -7 to -4	E -4 to -2	E -4 to -2
ABCP	L -5 to -3	L -5 to -3	E flat to +3	E flat to +3

## Upcoming Conferences & Events

**June 6<sup>th</sup> – 7<sup>th</sup>**

**June 12<sup>th</sup> – 15<sup>th</sup>**

**July 10<sup>th</sup>**

**July 12<sup>th</sup>**

**October 16<sup>th</sup>**

**November 5<sup>th</sup> – 8<sup>th</sup>**

**ASF Annual Meeting** – New York

**IMN's Global ABS Meeting** – Barcelona, Spain

**FitchRatings' Annual ABCP Conference** – New York

**Moody's PhDs of ABCP** – London

**IPMA/Moody's ABCP & SIV Conference** – London

**ABS East** – Orlando, Florida

*June 2006*

## **Structured Investment Vehicles : Structures and New Developments**

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*Written by Greg B. Cioffi, Seward & Kissel LLP*

**This article presents a brief introduction to SIV transactions and describes the new developments in SIV structures.**

Structured Investment Vehicles, or "SIVs", are market value based companies that incorporate many of the characteristics of traditional asset-backed vehicles, but at the same time have much of the flexibility of operating companies.

SIVs typically purchase highly rated medium and long-term assets and fund the purchase of such assets through the issuance of short-term highly rated commercial paper notes and medium-term notes (the "Senior Notes") and one or more classes of subordinated notes (the "Capital Notes") in order to generate a spread between the yield on the SIV's portfolio and its cost of funds.

As contrasted with collateralized debt obligations ("CDOs"), SIVs have no preset investment period and can generally continue to issue Senior Notes and Capital Notes (the "Notes") and to acquire assets, effectively for an indefinite period of time. In addition, the program documentation for SIVs generally allows for considerable flexibility to (i) include multiple series of Capital Notes and to introduce additional types of Senior Notes, such as extendible notes, (ii) increase the total outstandings, (iii) change the SIV's eligibility criteria and portfolio parameters, and (iv) engage in other activities not expressly contemplated by the program documents on the original closing date.

As a result of the flexible nature of the SIV structures, SIVs have proven to be highly resilient during periods of market volatility.

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### **PURPOSE**

Sponsors' principal motivations for establishing SIVs are the creation of a net spread to provide stable returns to the holders of the Capital Notes and the creation of management fee income. In addition, certain sponsors are motivated to provide attractive investment opportunities to their customers through the issuance of Capital Notes utilizing an off-balance sheet vehicle.

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### **STRUCTURE**

SIVs are established as bankruptcy remote limited-purpose vehicles in jurisdictions that afford beneficial tax treatment, such as the Cayman Islands and Jersey. The majority of SIVs issue the Senior Notes in both the U.S. and Euro markets in order to take advantage of pricing differences in these markets so as to reduce the SIV's cost of funds.

A United States wholly owned subsidiary of the SIV is routinely established to co-issue the Senior Notes in the U.S. market. In certain transactions, the U.S. subsidiary directly issues the U.S. Senior Notes, the repayment of which is guaranteed by the SIV.

The SIV appoints a manager (the "Manager"), an entity that is typically the sponsor or an affiliate of the sponsor, pursuant to a management agreement (the "Management Agreement"). The Manager provides investment advice and funding and operational support to the SIV and establishes the monitoring systems of the SIV. The Management Agreement and the compliance manual, which is prepared by the Manager (the "Compliance Manual"), sets forth the portfolio parameters, compliance tests, operating restrictions and reporting requirements for the SIV, as well as the back-up and disaster recovery arrangements that are required to be maintained. The Compliance Manual and the simulation models used to ascertain a SIV's compliance with the compliance tests described below are proprietary in nature, and typically only the SIV, the Manager and the rating agencies have access to such materials.

The flexibility inherent in the SIV structure is in part due to the latitude the Manager of a SIV has with respect to the operation and modification of the SIV. The Manager has considerable discretion to determine the composition of the assets that comprise the SIV's portfolio, to dispose of assets and to conduct the operations of the SIV. Subject to confirmation from the rating agencies, the Manager

can also modify the portfolio parameters and simulation models on behalf of the SIV to reflect changes in market conditions as well as technological innovations.

Traditionally, SIVs have been documented utilizing a U.K. trust structure pursuant to which the core program documents are governed by English law and a charge in the SIV's portfolio is granted to a U.K. "Security Trustee" for the benefit of the holders of the Notes and the other secured parties under a security trust deed. The core documents of certain of the more recent SIV transactions are governed by U.S. law and the portfolio of the SIV pledged to a U.S. "Collateral Agent" for the benefit of the holders of the Notes and the other secured parties pursuant to a U.S. law governed security agreement. The structure selected will affect, among other things, the manner in which the SIV's portfolio is liquidated and the roles certain relevant parties to the program documents will play in such liquidation.

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## **ASSET PORTFOLIO**

Generally, the portfolio of the SIV is marked to market on a daily basis by the Manager in accordance with a pricing methodology which is set forth in the Compliance Manual. The central issue to the rating agencies in rating SIV transactions is to ascertain whether, following the wind-down of the SIV, the Senior Notes will retain their rating levels until the last Senior Note has been repaid in full.

SIVs are also subject to a variety of portfolio parameters agreed upon with the rating agencies. While the portfolio parameters and individual eligibility criteria for each SIV program vary, these limits generally seek to ensure that the credit quality, diversity and liquidity of the SIV's portfolio are sufficient to support the ratings of the Senior Notes. Typically, the breach of the SIV's portfolio parameter either will impact the "Capital Adequacy Test" described below or will result in the SIV entering into a more restrictive operating mode with the severity of the impact being dictated by the nature and extent of the breach. As more fully described below, depending upon the severity of the breach, the SIV could be required to wind-down.

The SIV will also be required to hedge its currency and interest rate exposure within very stringent parameters. Since the counterparties to such hedging arrangements are not supporting the ratings of the SIV's Notes, such counterparties are only required to have an investment grade rating. However, the exposure to each such counterparty is treated as an asset for purposes of the Capital Adequacy Test.

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## **COMPLIANCE TESTS**

On each business day, the Manager will perform, in accordance with the SIV's investment guidelines and operating parameters, a series of financial tests to determine the SIV's exposure to liquidity, interest rate, market and leverage risks. These tests (the "Compliance Tests") customarily consist of the following:

Capital Adequacy Test. The Manager will conduct a test to determine if the market value of the SIV's portfolio reduced by capital charges in respect of the assets of the portfolio is sufficient to cover the payments required to be made on the Senior Notes and other senior liabilities of the SIV.

Liquidity Adequacy Test. In order to manage and reduce the risk relating to funding longer-term assets with short or medium-term liabilities, the Manager will monitor the SIV's forward schedule of payments and anticipated receipts on each business day and perform various tests on these schedules.

Interest Rate F/X Sensitivity Test. The Manager must also monitor the SIV's total portfolio with respect to changes in interest rates and foreign exchange rates. The Manager runs a test, on a daily basis, to determine if the resulting changes in the value of the SIV's portfolio are within the predetermined parameters.

Leverage Compliance Test. The Manager will also typically run a test to determine if the capital of the SIV is leveraged within pre-established limits.

Many SIVs have differing thresholds for each Compliance Test in order to measure the severity of the noncompliance, and depending upon the severity of such non-compliance, the SIV could be required to limit its operations or to wind-down.

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## **MODES OF OPERATION**

The Management Agreement and the Compliance Manual will often describe a number of operating modes for the SIV that are triggered by certain events. The nature and severity of the triggers, as well as the number of operating modes, vary among SIV transactions. Generally, these triggers include non-compliance with Compliance Tests, ratings downgrades, and breaches of certain of the SIV's portfolio parameters.

The trend among most of the newer SIVs in the market is to have multiple modes of operation, such as a "Normal Operations Mode", a "Limited Operations Mode", a "Defeasance Mode" and an "Enforcement Mode", so as to establish multi-level early warning systems giving the Manager ample time to return the SIV to full compliance.

If the SIV enters the Enforcement Mode, it can not return to the Normal Operations Mode and the Collateral Agent or the Security Trustee will enforce the security interest of the holders of the Notes and the other secured parties by liquidating the portfolio in accordance with the SIV's established "enforcement guidelines". The SIV's enforcement guidelines will reflect the assumptions upon which its capital model has been based. For instance, the capital model for certain SIVs assumes that all Senior Notes and other senior liabilities will be paid in full within one year after the commencement of the Enforcement Mode, while the capital model for other SIVs assumes that assets in the SIV's portfolio will be sold only as the liabilities of the SIV come due.

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## **DEVELOPMENTS**

Since the first SIV transaction was established in 1988, SIV structures have evolved substantially. Early SIVs utilized a static matrix or "hair cut" approach to determine if the capital cushion that protects the holders of the Senior Notes was sufficient to maintain the ratings of such Notes. All of the more recently established SIVs use some form of dynamic simulation model based on risk factors that affect the SIV's performance, such as the tenor of the Senior Notes, derivative exposure, asset maturity, liquidity, ratings of the assets and exposure of the portfolio to obligor, geographic industry and other concentration limits. The current state-of-the-art approach is to utilize a "Monte Carlo" simulation approach. Moody's has developed a capital model for application to SIVs based upon the Monte Carlo simulation, a description of which is available on its web site.

SIVs have also added additional modes of operation so as to mitigate the possibility that the SIV will enter into the Enforcement Mode, and have increased the classes of Capital Notes and the types of Senior Notes being issued.

The permitted activities of the SIVs have also broadened greatly to include securities lending activities and the selling of credit default swaps. The portfolios of SIVs have also expanded well beyond the traditional portfolios of investment-grade debt securities. For example, Seward & Kissel has recently acted as transaction counsel for a very innovative SIV, the portfolio of which is primarily comprised of non-investment grade senior bank loans.

The program documents for certain of the more recent SIVs have incorporated the ability of the Manager to allocate the assets of the SIV into one or more separate portfolios on its books and records. This structural innovation is designed to permit one or more additional investment managers to be appointed to effectively manage separate investment portfolios within the SIV.

Recently, we have also seen the emergence of a new variation of the traditional SIV structures, referred to by the industry as "SIV lites". Although the rating agencies have yet to publish any specific criteria, SIV lites utilize significantly higher equity leverage and have portfolios comprised of assets with higher spreads as compared to traditional SIVs.

As the portfolio of SIVs and CDOs increasingly overlap, CDOs with market value structures and commercial paper tranches become more prevalent, the lines between SIVs and CDOs are becoming increasingly blurred.

From all indications, 2006 promises to be an exceptional year, both in terms of the number of new SIVs that go to market and the innovations adopted by the new programs.

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## Previously Published ABCP Articles

- 2006: Recount Please: Fed Amends Programs Included in ABCP Outstandings  
Basel II Press Release – Federal Reserve Releases Notice of Proposed Rulemaking for Basel II in U.S.
- 2005: Basel II Press Release – Banking Agencies Announce Revised Plan for Implementation of Basel II Framework  
Rating Agencies Report Updated Views on Katrina Affected Properties in New MBS Transactions  
Application of Fitch Rating's VECTOR CP Model for Evaluating Program Wide Credit Enhancement  
New Developments in Asset Backed Commercial Paper
- 2004: As Supply Trends Shift, Disco/CP Spreads Should Widen  
Basel II and the Implications for the ABCP Market  
Comparison of Rating Agencies' Surveillance Web Sites  
Update on the Revised US Regulatory Capital Rules  
Basel Press Release - Summary of Decision Related to Securitization – Treatment of Unrated Exposures
- 2003: Standard & Poor's Refines Liquidity Provider Criteria for Japanese ABCP Programs  
Accounting Consolidation and True Sale Opinions  
Risk-Based Capital Treatment of ABCP Programs and Possible Capital Charge For Early Amortizations  
GSEs' Discount Notes Crowding Out CP Issuers  
FIN 46, New Rule Could Surprise Investors  
FIN 46, Regulatory Relief, and U.S. ABCP Conduits  
FIN 46 Not Expected To Change U.S. Bank Sponsors' "Well Capitalized" Status or Ratings  
The Impact of FIN 46 On The Application Of Rule 2a-7 Of The Investment Company Act  
Standard & Poor's Introduces 10% Limited Liquidity Basket to Rated Money Market Funds in Light of Increased Risks  
New Tax Shelter Disclosure and List Maintenance Regulations
- 2002: Summary of CSFB's "The Status of the FASB Consolidation Project and EITF Issue No. 02-12" Teleconference Call  
Bank Downgrades Highlight Importance of Global Structured Finance Criteria  
U.S. Market Conditions Ripe for Floating-Rate ABCP Growth  
Better Disclosure, Not Consolidation Wanted By Industry  
SEC No Action Letter Could Make Offshore CP Issuances Easier for U.S. Conduits  
Federal Banking Agencies Determine that Covenants Tied to Supervisory Actions in Securitization Documents are an Unsafe and Unsound Banking Practice.  
U.S. Risk Based Capital Standards—Reduced Risk Weight Claims on Qualifying Securities Firms  
Implications of the Impending Elimination of Withholding Tax on Interest Payments Between the U.S. and Canada  
The FASB Consolidation Project (transcript of the teleconference).  
"Audits" or "Inquisitions": Law, Financial Markets and Accounting in the Wake of Enron  
Moody's and Standard & Poor's Issue Special Reports
- 2001: United Kingdom – Charges over Book Debts  
Revisions to the U.S. Risk-Based Capital Requirements for Banks (transcript of the teleconference).  
How to Get the Most from Your Commercial Paper Program  
Rating Agencies Comment on ABCP Market Performance During Week of September 11th  
Key Changes in UK Regulation Relating to Issuance of Commercial Paper  
Issues to Consider by ABCP Conduits Purchasing Highly Rated Securities  
The Proposed BIS Guidelines: The ABCP Industry's Comment (transcript of the teleconference).  
Risk Management Under FAS Rules: Application of FAS 133 to an Interest Rate Hedge (using the short-cut method)  
Revisions to Article 9 of the Uniform Commercial Code (transcript of the teleconference).  
Asset Backed Commercial Paper Demand Increases as Money Market Funds Increase Holdings  
The Development of an ECP Investor Base and its Effects on ABCEP Issuance  
LTV Bankruptcy Case and its Impact on Securitization (transcript of the teleconference).  
Clarification of the "Legal Isolation" Condition for Banks Under SFAS 140: 12 CFR Part 360.6  
The Use of Derivative Contracts in ABCP Programs: Some Legal Considerations When Using Credit Derivatives

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